PREFATORY NOTE

These transcripts have been produced from the original raw transcripts in the FOMC Secretariat's files. The Secretariat has lightly edited the originals to facilitate the reader's understanding. Where one or more words were missed or garbled in the transcription, the notation "unintelligible" has been inserted. In some instances, words have been added in brackets to complete a speaker's thought or to correct an obvious transcription error or misstatement.

Errors undoubtedly remain. The raw transcripts were not fully edited for accuracy at the time they were produced because they were intended only as an aid to the Secretariat in preparing the records of the Committee's policy actions. The edited transcripts have not been reviewed by present or past members of the Committee.

Aside from the editing to facilitate the reader's understanding, the only deletions involve a very small amount of confidential information regarding foreign central banks, businesses, and persons that are identified or identifiable. Deleted passages are indicated by gaps in the text. All information deleted in this manner is exempt from disclosure under applicable provisions of the Freedom of Information Act.

Meeting of the Federal Open Market Committee

August 24, 1982

A meeting of the Federal Open Market Committee was held in the offices of the Board of Governors of the Federal Reserve System in Washington, D. C., on Tuesday, August 24, 1982, at 9:45 a.m.

PRESENT: Mr. Volcker, Chairman
Mr. Solomon, Vice Chairman
Mr. Balles
Mr. Black
Mr. Ford
Mrs. Horn
Mr. Martin
Mr. Partee
Mr. Rice
Mrs. Teeters
Mr. Wallich

Messrs. Keehn, Morris, and Roos, Alternate Members of the Federal Open Market Committee

Messrs. Boykin and Corrigan, Presidents of the Federal Reserve Banks of Dallas and Minneapolis, respectively

Mr. Axilrod, Staff Director
Mr. Bernard, Assistant Secretary
Mrs. Steele, Deputy Assistant Secretary
Mr. Bradfield, 1/ General Counsel
Mr. Oltman, 1/ Deputy General Counsel
Mr. Mannion, Assistant General Counsel
Mr. Kichline, Economist

Messrs. J. Davis, Keran, Koch, Parthemos, Prell, Truman, and Zeisel, Associate Economists

Mr. Sternlight, Manager for Domestic Operations, System Open Market Account
Mr. Cross, Manager for Foreign Operations, System Open Market Account

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1/ Entered the meeting following the action to ratify System open market transactions in foreign currencies.

Messrs. Czerwinski and Smoot, First Vice Presidents, Federal Reserve Banks of Kansas City and Philadelphia, respectively

Mr. Coyne, Assistant to the Board of Governors
Mr. Gemmill, Associate Director, Division of International Finance, Board of Governors
Mr. Kohn, Senior Deputy Associate Director, Division of Research and Statistics, Board of Governors
Mr. Promisel, Senior Deputy Associate Director, Division of International Finance, Board of Governors
Mr. Lindsey, Assistant Director, Division of Research and Statistics, Board of Governors
Mrs. Low, Secretary, Open Market Secretariat, Board of Governors

Messrs. Eisenmenger, Fousek, Scheld, and Stern, Senior Vice Presidents, Federal Reserve Banks of Boston, New York, Chicago, and Minneapolis, respectively

Messrs. Burger, Cacy, and Soss, Vice Presidents, Federal Reserve Banks of St. Louis, Kansas City, and New York, respectively

Mr. Pearce, Assistant Vice President, Federal Reserve Bank of Dallas

Mr. Lang, Research Officer, Federal Reserve Bank of Philadelphia
Ms. Lovett, Securities Trading Officer, Federal Reserve Bank of New York

Transcript of Federal Open Market Committee Meeting of August 24, 1982

CHAIRMAN VOLCKER. Would someone like to propose approval of the minutes?

SPEAKER(?). So moved.

SPEAKER(?). Second.

CHAIRMAN VOLCKER. Without objection. Foreign currency operations, Mr. Cross.

MR. CROSS. [Statement--see Appendix.]

CHAIRMAN VOLCKER. Let's ratify the exchange market transactions first and then we will discuss Mexico.

SPEAKER(?). So moved.

SPEAKER(?). Second.

CHAIRMAN VOLCKER. That's ratified. I didn't mean to shut off any questions, but let's discuss Mexico. Who is going to present a proposal here--Mr. Cross or Mr. Truman or me?

MR. CROSS. We defer to you on the assumption that you would want to make a proposal, Mr. Chairman.

CHAIRMAN VOLCKER. Well, we discussed this late last week. What has happened since then is first of all the bank rollover and the bank discussions about putting up additional money, which I'm sure will be continuing [for] some time. The calculations are a little slippery at this point, but the presumption is that our present swap [loan to Mexico] of $700 million has a priority claim on any Fund drawing, assuming there is a Fund drawing in the next couple of months. And, therefore, Mexico would get no net money--or very little, depending upon how that worked out--from the Fund during this period. And without any net money from the Fund, even with some additional official assistance during the course of the next two or three months, they're going to need more money. That proposition--that the banks would have to put up some additional net new money in addition to the rollover--was put to the banks and they have studied it. That was presented to a degree as a--well, "requirement" may be too strong a word--but an expectation of what would lie behind official assistance, so that to some degree these things work in parallel. In fact, I don't think the banks will make up their minds about this for some days or maybe a week or two, and some additional official assistance will be needed before then. I might mention that at a meeting in New York where there were maybe 200 people and about 90 banks or whatever represented--

VICE CHAIRMAN SOLOMON. 115 banks.

CHAIRMAN VOLCKER. It got up to 115 banks? Mr. Solomon made a little introductory statement describing the nature of the official program and indicating that there was some expectation of some private bank new money as part of this. I don't remember anything else that was of particular significance, Tony, but my memory may fail me and you might want to comment.

VICE CHAIRMAN SOLOMON. I just outlined the package, which you're probably all familiar with from the press. And basically the Mexican presentation boiled down to their saying that the Fed would be repaid first on the $700 million swap; they told the banks that the only net new money between August and December would be approximately $1.4 to $1.5 billion--basically the extent of the BIS package to complete an extra additional [unintelligible]. They said they had need of $1.9 billion, assuming everybody rolled over [their existing loans] and they had to build some reserves. Therefore, this justified something close to a billion dollars in new money as being essential. About 25 bankers spoke up. Quite a few of them said they would cooperate, implying they'd cooperate on the rollover; some implied they would cooperate as well in sharing in the new money. Nobody got up and said no. Based on that, the Mexicans felt justified, and I think correctly so--though they put it a little more strongly than I think we would have said it--in stating that there was an agreement in principle on the rollover. We might have said instead that there was a consensus in principle on the rollover; they said there was "agreement." But then they followed that up with telexes on Friday night and Saturday morning to the individual banks to get a legal, formal agreement on the 90-day rollover. The advisory group said they had put together fourteen banks. The two co-chairmen, from the Bank of America and Citibank, are working on the question of new money and whether they can get part of that from the other banks, not just from the fourteen. As Paul said earlier, one of their conditions on the new money is basically to see the Fund program. That doesn't mean they would want to wait until it is written up and every "i" is dotted and every "t" is crossed, but they have to have a basic understanding of the Fund program before they will come up with any money. I think that's it.

CHAIRMAN VOLCKER. Just to clarify, we're looking at this in several stages. When we talk about the Fund program, that in itself will be in two stages, hopefully. There was talk that sometime in early September--how soon it actually will take place, I don't know, but I suspect it will be later than they were indicating a couple of weeks ago--agreement in principle on a Fund program could be reported to the public and the outline of the program would be known, but it would take another month beyond that to go through the process of actually getting the Fund agreement locked up, executive board approval [obtained], and the money ready to be disbursed. So, we're talking about Fund money not being disbursed before the middle of October at the earliest. But the hope is that there would be an understanding on the terms as early in September as possible. And this bank money that is being talked about presumably would wait for that first phase of the Fund program, not the second phase. But that's temporary money; I don't know what the terms would be. It's clear that Mexico is going to need more money next year--not just the Fund money, which will largely go to repay the short-term official assistance, but money on which to survive for a period of time next year. And that will take another negotiation after this initial $1 billion that is being mentioned here or whatever it is. That presumably would be a negotiation that would proceed during October and November and maybe December.

MR. MARTIN. The $1 billion assumes all the banks hold still? No small banks have to be paid off?

CHAIRMAN VOLCKER. Well, you say no small banks. I think that's an obscurity. The banks don't want many [current bank lenders] to be paid off, that's for sure. When there are a thousand plus banks out there, the problem is: How do you control them all? But if very many of them wanted to get out, the whole [deal] might blow up.

That brings me back to the swap line. I forget just where we were when we talked on the telephone but there was an agreement in principle in Basle early last week for [official loans totalling] $1.5 billion, meaning $750 million from the United States and $750 million from the other countries. Those countries are insistent upon a basically equal sharing that does not take account of the $700 million of new money we already have in there. The $750 million consisted of amounts as high as   million for Canada and Japan,   million for the United Kingdom and   million for Germany. Then the amount pretty quickly drops down to   million for essentially all the rest of the G-10 countries. I think they're all in, aren't they? Well, with an exception of one or so, that was tentatively agreed on. The reason it was $1.5 billion was that that was all the Mexicans asked for, even though they think they need more. Mr. Silva Herzog, the Finance Minister, sort of clinched that by saying in his television address in Mexico that he was discussing $1.5 billion because he wanted to put a figure in his speech and he didn't want to ask for more than he knew he could get. That was the explanation, I guess. But once the Europeans heard that, they said no more than $1.5 billion but with some understanding, at least among some of them that I've talked to, that the Mexicans might have to come back for more.

Now, subsequent to that and subsequent to our conversation, the Bank of Spain, or the Spanish authorities anyway, who did not attend this meeting in Basle have volunteered   million as a gesture of good will to their Spanish-speaking brethren in the New World. That is the biggest single amount that any country has come up with. They have had a swap agreement with Mexico, and apparently that swap is more meaningful than I might have thought, or so they have interpreted it. So that would bring the European amount up to $925 million and they want us to match it. I have, of course, discussed this with the Treasury and they have agreed to put up $600 million. That leaves us with $325 million if we fully match [the other countries]. The idea here is that we will all go in together. The European side will be done through the BIS, and the BIS is technically putting up the money with various kinds of support from the central banks or the governments. We will not be in that technical arrangement, but the understanding is that we will provide the money in parallel to their providing the money. They don't have the same degree of flexibility that we do in timing because they have to raise the money in the market, and they like to go by a schedule and have some warning as to when they're going to put up the money. They just can't sit there and say "How much do you need this morning?" and put it up the way we can. But the understanding at this stage is that they will put it up in three tranches, and this is deliberate so that at no time are we providing much more money than the Mexicans need. And we will put it up with a mutual understanding, which will be written into our swap agreement and into the Treasury's swap agreement and reflected in some way in their agreement, that this money will be provided over the coming weeks as they need it but with an option on our part to evaluate the wisdom of putting up any amount of money in the light of progress on negotiations with the Fund, with language about looking toward an agreement with the Fund by the middle of September. You may have some exact language there that you can provide, Ted, but that's the general concept. We may not put up our money dollar for dollar with theirs, because theirs will come in lumps. We will put it up as it is needed from day to day and the Europeans won't come in with a second tranche until we catch up with them on the first tranche or maybe exceed them by a few million dollars. And then they will come in with a second tranche and we'll catch up with that and proceed in that manner so that Mexico at no time will have any very great amount of money in the bank while we are observing progress with the Fund. What is that language you have or the nearest approximation you've arrived at now, anyway, Ted?

MR. TRUMAN. It says: "It is understood that the Government of Mexico is seeking to reach agreement on the program from the IMF by September 15 and it is further understood that it is the mutual expectation of the Bank of Mexico and the System that the last one-third of the funds available on the swap arrangement would not be drawn until the Bank and the management of the Fund have reached agreement on Mexico's economic stabilization program." So, the last one-third of the whole package and the timing of the BIS third tranche is linked to their essentially having reached agreement in principle with the Fund.

CHAIRMAN VOLCKER. And the date mentioned is September 15. Also, we do look forward to some private money here but, in my judgment, that's probably not going to be before the middle of September. It likely will be triggered by the same agreement with the Fund. That's probably desirable at this stage because it's nice to get private money in there in one sense; on the other hand, I think they need all the encouragement they can get to reach agreement expeditiously with the Fund, and that is one way of putting more pressure in that direction. Any questions or comments?

MR. PARTEE. Paul, I just want to raise a difficult issue and that is the question of quality of credit. The Federal Reserve is traditionally concerned about the quality of the credit that it extends. At the discount window we require collateral and we take haircuts on bonds and that kind of thing to be sure that we have collateral. We have sometimes said that we would not lend to an institution that was no longer solvent, although that's a very iffy matter and I'm not sure that that has much point. But I do make the point that we have been very careful in the administration of the discount window as a traditional matter to see that we were well secured. In cases where we were approached for lending in special circumstances, such as in the case of Lockheed or New York City, we've been reluctant and we have said that it had to be bridge financing. In the case of New York City in particular, I recall that we said we couldn't see the other end of the bridge, but it was bridge financing without much, really, in the way of meaningful collateral that New York City could ever put up. In the case of the other swaps in which we were engaging, I guess we have always felt--although we never really tested it--that the countries were solvent. In the case of Mexico, one of the things that disturbed the Committee when it considered [establishing] the Mexican swap was the question of whether at some time or other Mexico would get to be in financial difficulty and there would be some question about the quality of the swap. We seem to be in exactly the same--

CHAIRMAN VOLCKER. We are precisely there. They're in financial difficulty; there's no question about that.

MR. PARTEE. That's right. We are precisely in the situation the Committee was somewhat concerned we might be in when that swap was first approved some 15 years ago. So, from my point of view in trying to sort through all this, the parallel becomes the bridge. I would feel as strongly as a private banker that I'd want to be convinced that something would be worked out to make the country okay.

CHAIRMAN VOLCKER. Well, I forgot to describe the collateral side. I think the fundamental point is the one you just made: None of this is going to work unless there is a good [economic] adjustment program. And it's going to have to be a very draconian adjustment program. I think we have to recognize the full extent of the limitations on that program, which I'm not in a position to judge, certainly at this stage. I'm not sure that anybody can judge how much the country can take. A country can have a fine-looking draconian adjustment program but if the country goes up in revolution, it will be unsuccessful. And I'm not sure the Mexican citizenry is fully aware yet of what has hit them, to say the least. But that has to be the fundamental backstop of any credit. We have labored long over the collateral issue and there aren't any terribly satisfactory answers because Mexico doesn't have that much collateral. But there are answers, satisfactory or not. The idea of this is that our present swap will remain secured, if that's the word, by a Fund agreement that doesn't exist yet. But if it does come into existence, our swap will have first claim on it. This second loan--and the proposal is that this would be a separate swap--will be secured along side the BIS arrangement with the remainder of the Fund drawings as they are available over time. I guess we have the gold [collateral] by implication. They are willing to pledge $250 million in gold, which doesn't go very far, but there it is. And by some assignment yet to be worked out, oil revenues are an ultimate backstop if nothing else works. Ted, maybe you're more up-to-date on that negotiation than I am. The BIS people are in Mexico City discussing that now.

MR. TRUMAN. Mike was just on the phone with them.

MR. BRADFIELD. The arrangement that has now been worked out between the Bank of Mexico and the BIS as far as a direct assignment by debtors, that is to say oil companies, is that Exxon and other oil companies in the G-10 countries [will assign] to the BIS an amount in excess of what would now be $1825 million of the total amount of the credit extended. The assignment would be substantially in excess of that amount, somewhere around $2.5 billion in total.

MR. PARTEE. This is on future oil deliveries?

MR. BRADFIELD. These are future oil deliveries. The assignments would be made now and would begin to flow into the BIS sometime, maturing one year from now.

VICE CHAIRMAN SOLOMON. Does this reflect the oil that was previously in hock to the private banks?

MR. BRADFIELD. No, the arrangements will clearly provide that they would have to assign oil that has not been previously assigned. It would be oil revenues under contracts that exist now and that would be free from other encumbrances.

CHAIRMAN VOLCKER. It's assigned to the BIS but we get a share of that to the extent that our--

MR. BRADFIELD. The BIS is our agent for the collection of these revenues.

MR. PARTEE. We are fully covered?

MR. ROOS. If their picture became more dismal and there were a political reaction down there, obviously these types of agreements would be rather meaningless, wouldn't they? There is no way--unless we build oil tanks in all of our new Fed buildings--

CHAIRMAN VOLCKER. I don't think there's any way of getting absolute protection against that kind of eventuality. Let me also recognize another bit of reality. Whatever arrangements we make for collateral, including our own swap, we may get to the point where Mexico has no money to pay, in effect. They may have some oil revenues, let's say, but whether we demand the oil revenues under those circumstances is going to have to be a decision made at the time. If we're going to bankrupt them by demanding the oil revenues, we may want to roll over the swap and make a new oil revenue deal later. That's not the intention, but I think that's inherent in the situation. When a country or a borrower doesn't have any money, he doesn't have any money no matter what kind of--

MR. BRADFIELD. I would agree with the Chairman that the latter problem is the more serious one. There are problems with the technical aspects of the assignment, but I would like you to understand that the assignment is an assignment of revenues by companies that operate outside of Mexico. So, there would be no way that those companies could get out of the assignment, theoretically.

CHAIRMAN VOLCKER. If the oil showed up.

MR. PARTEE. If the oil was delivered.

MR. BRADFIELD. But I assume that Mexico has to deliver the oil; they have to sell oil.

VICE CHAIRMAN SOLOMON. There's a lot of oil that is already assigned. I don't know if you have the numbers, Michael, on what is already assigned to private banks.

CHAIRMAN VOLCKER. I'm not sure anybody does.

MR. BRADFIELD. We are trying. Mr. Patrikis [of the New York Federal Reserve Bank] is in Mexico City, and one of the things we have asked him to do is to collect all of the appendices and agreements for assignment.

CHAIRMAN VOLCKER. They have done a lot of these deals--increasingly in recent months--but they told us that a relatively small fraction has been placed. Now, whether that's true or not, I don't know; but that's the story they gave.

MS. TEETERS. What is the annual or monthly flow?

CHAIRMAN VOLCKER. They get $15 billion dollars a year, roughly, from oil at current levels of production and current prices. So there's quite a lot of flow there. The monthly flow is--

MR. TRUMAN. A billion and a quarter dollars.

MR. RICE. Is that total production or exports?

CHAIRMAN VOLCKER. That's exports.

MR. WALLICH. We want to bear in mind that Mexico a few years ago was a reasonably viable country without oil. At the same time there is a basic economy that can function; the oil is an addition.

MR. BLACK. Mr. Chairman, I'm not clear on one thing. Is it anticipated that we would use the funds from the IMF to settle that $700 million drawing?

CHAIRMAN VOLCKER. It's anticipated now, but I can also anticipate a problem. If that money comes through on November 1 or October 15, say, and they have no other source of money and don't have the money to pay us, we may be faced with a decision on a rollover.

MR. BLACK. But in setting our share, they made that assumption I gather, didn't they?

CHAIRMAN VOLCKER. Everybody understands that we have a prior claim on IMF money from the earlier swap. Whether we can cash in on that claim or not remains to be seen. But legally that's the position. I also want to mention the rate. I don't know whether we finally settled on this, but ordinarily we lend essentially at the Treasury bill rate on these things; the BIS is going to lend at LIBOR plus which raises the question of whether they should be getting more than we would be getting; right in today's market it's several percentage points. More normally it would be a significant margin but not quite as big as it is at the moment. So, we have discussed a possibility--this is the BIS agreement and I presume ours would be parallel--that the second swap would have a 3-month maturity and could be rolled over 3 times, which makes it a 1-year loan potentially. And thus there might be some logic in using the one-year bill rate and marking it up point or something, which comes much closer on average to where LIBOR has been in the past. Nobody knows what it will be in the future. But it is natural to do the same thing as the Treasury; I don't know whether we've resolved this with the Treasury yet or not.

MR. TRUMAN. They accepted that proposition--using the one-year Treasury bill rate on the yield basis off the constant maturity series that we publish.

CHAIRMAN VOLCKER. Plus

MR. TRUMAN. Plus

CHAIRMAN VOLCKER. It probably will come out cheaper than LIBOR, but that depends upon the shape of the yield curve. If we had a steeply rising yield curve, it would not; if we had a relatively flat yield curve, it would be less than LIBOR. But it's someplace in the ballpark. So, that's the interest rate that we are talking about.

Let me ask whether there are any other questions or comments about this in general. If there aren't, we're only left with the decision of whether to do $300 million, which makes [the total] a nice round billion dollars, which is what I was thinking of when I talked with you before. I guess the Europeans will live with that. So, the U.S. share would be $900 million and the European share would be $925 million. Or we may want to make a grand gesture and throw in another $25 million and make our share equal.

MR. PARTEE. Would this be classified just as an addition to the swap or is it a special--?

CHAIRMAN VOLCKER. No, it's a new swap.

MR. PARTEE. It's a special thing.

CHAIRMAN VOLCKER. This is a different swap as we have it structured now so that it can be parallel with the BIS lending and the [original] $700 million swap will be held where it is.

VICE CHAIRMAN SOLOMON. I'm not so much worried about the Mexicans, but the Europeans will not really understand why we were so chintzy if we come in $25 million short of the 50-50 match. I personally would put in for it.

MR. FORD. Are we going to offend the French, Tony?

CHAIRMAN VOLCKER. The only consideration I can see on the other side is that we will be discussing this with the Europeans in Toronto, I'm sure, and I can see how things go. If they have really shut off the principal payments on their loans, this should be enough, particularly if we want private banks to come in. But there's always a possibility that there will be a need for a few hundred million more along the line here someplace, so I want to warn you about that. But this should be enough as I now see it. Well, I'll put it conservatively: The calculations now assume that they get a pretty full rollover from the private banks; assuming that the private banks do come in once there is a Fund agreement, this should last them through the Fund agreement if that's successful. And after the Fund agreement in principle, at that point if the banks come in for some more, I do not see that we're going to have to put up any more. That's my judgment at the moment, but I would not promise you that the Mexicans are not going to run out [of dollars] during the next two to three months.

MR. ROOS. Are there other problem situations in that part of the world that conceivably are likely to follow or fall into the same [difficulties]?

MR. MARTIN. Argentina, Brazil, and Venezuela for example?

CHAIRMAN VOLCKER. Argentina is the most imminent of those, I think. It's a different situation in many respects, but just in terms of our own posture--and it's worth discussing briefly--we have no swap agreement with Argentina. We have always refused to extend [the swap network]; this [swap line] with Mexico is somewhat of a special deal with a neighbor. The Mexican currency was convertible. That is not true generally of Latin America in the same sense. I think we have reason to hold the line as the Federal Reserve. What the U.S. government would want to do in the case of Argentina is something else again. I imagine that if Argentina gets into this kind of jam, the question is going to be raised. But we do have a distinction in what we have done in the past and in our general attitude between Mexico and Argentina, just to take the next most imminent [problem economy]. Brazil, Venezuela, and others could be involved, too, but I think Argentina is the most imminent. Now, their debt is a lot smaller, of course. It's very sizable, but it is less than half the size of Mexico's. It's not all that much less than half, I guess. What is it--about $30-odd billion?

MR. TRUMAN. $35 billion.

CHAIRMAN VOLCKER. $35 billion; it has gotten big, too.

MR. TRUMAN. [Unintelligible.]

CHAIRMAN VOLCKER. Our banks are heavily involved, but not as heavily as in the case of Mexico; I presume about half as much. The $325 million proposition is on the table; it may even have been seconded. To make it a little more formal than was expressed, it makes some sense to me, so long as we have these understandings, that we don't appear to be chintzy for $25 million.

MR. PARTEE. Is the $600 million from the Treasury solid?

CHAIRMAN VOLCKER. What do you mean by solid? They've agreed to it right now. I don't know if the paper is signed yet, but I--

MR. PARTEE. It just occurs to me that they have not done this; they have not had the benefit of a Congressional appropriation and they must be trying to get the money in some other place.

CHAIRMAN VOLCKER. They don't do it. It's the ESF.

MR. PARTEE and MS. TEETERS. They have some money?

CHAIRMAN VOLCKER. Yes.

MR. PARTEE. I didn't think they had any money left.

CHAIRMAN VOLCKER. They have put up $1 billion for this for a week or so to bridge the Department of Energy's payment. So, they have a billion dollar swap right today. Now, that will be repaid today or tomorrow. Did they reach agreement on that oil thing?

MR. TRUMAN. No, not yet.

CHAIRMAN VOLCKER. They are still negotiating the details of this oil thing. But presumably that will be settled in a day or two.

Their billion dollar swap will be repaid and then they will come back in proportionately.

MR. PARTEE. That August 24 date that Sam mentioned--I believe that's today.

MR. CROSS. That's right.

MR. PARTEE. August 24 is today, isn't it?

MR. TRUMAN. Yes. We just confirmed that [date].

CHAIRMAN VOLCKER. It was supposed to be agreed to yesterday, but I know it was put over until today. It sounds as if it's being put over until tomorrow.

MR. CROSS. It matured today but it may be extended a day or two if they don't work out that problem.

VICE CHAIRMAN SOLOMON. The ESF is in a much healthier condition than when I was there.

MR. PARTEE. Are they really? I just have not kept track of it, Tony.

VICE CHAIRMAN SOLOMON. It's the combination of all those drawings that we did from the IMF when we did the November 1 package, which we don't have to repay, so it only appears on the asset side of the ESF. But all these high interest rates that the Federal Reserve is giving these countries has put the ESF in a very healthy condition.

CHAIRMAN VOLCKER. Now, under the law under which the ESF currently operates, if [the loan] is outstanding for more than six months, they have to get a Presidential determination that this is a special situation that justifies lending for more than six months. I think they intend to get that Presidential determination right now.

MR. TRUMAN. Yes, they do intend to do that. As a matter of fact we saw the draft last night. They would have it as part of the package.

VICE CHAIRMAN SOLOMON. I would say that there would be very strong support from the Congress. The thought of economic chaos in Mexico, with all those millions of people trying to pour in over the border, is just so upsetting to members of the Congress that I think there would be widespread support.

MR. MARTIN. The month after they pass the first big change in the immigration statute in 30 years or whatever it is!

MR. PARTEE. Well, of course, there's likely to be enough economic hardship in Mexico that there will be flight across the border anyhow.

CHAIRMAN VOLCKER. Yes, we're going to get it anyway.

VICE CHAIRMAN SOLOMON. But there is a perceptible difference between austerity programs and actual collapse.

MR. MARTIN. For 70 million people, you know!

CHAIRMAN VOLCKER. Well, we have a motion for $325 million. The exact [terms] I'm going to say are available to you; I'm not sure the language is all worked out to the last comma. The main elements have been touched upon: the rate, the collateral, the term of 3 months, and the rollovers for a year. The implication is that we would be repaid during the course of the year, as the Fund money becomes available, but that's not promised.

MS. TEETERS. Do we get paid back equally with the BIS? Is that the idea?

CHAIRMAN VOLCKER. Yes, out of the same pool equally.

VICE CHAIRMAN SOLOMON. I don't think we can all get out in a year because they can only draw a maximum of about $1-1/4 billion from the Fund in the first year, or maybe $1-1/2 billion if they front load. So, if you take--

CHAIRMAN VOLCKER. It would be a little more than that if they front load.

VICE CHAIRMAN SOLOMON. We have our $700 million and we will get a part of the BIS--

CHAIRMAN VOLCKER. Well, we don't know; it depends upon whether they get a compensatory financing facility [drawing from the IMF] and how much is front loaded. But with $1.8 billion and $700 million you have $2.5 billion. That is more than front loading alone would provide out of the Fund agreement.

MR. PARTEE. And their own circumstances could improve. There could be an increase in oil prices, for example.

CHAIRMAN VOLCKER. Well, if it really worked out well, we would get paid out of private financing. The banks would put up more loans and Mexico would repay us; but we may be dreaming, too.

MR. PARTEE. Of course, if oil prices decline--

CHAIRMAN VOLCKER. We have gotten 9 different stories in the course of this negotiation about whether they can, among other things, increase their oil production or not. Two weeks ago they were going to increase it way up; this week, no. It's going to be a difficult negotiation. Do I take silence as assent?

MS. TEETERS. Do you want a formal vote?

CHAIRMAN VOLCKER. Well, we'll have a formal vote if anybody wants to object. Not hearing any objections I think the Secretary can record it as unanimous.

MR. PARTEE. Yes, we do want it recorded.

CHAIRMAN VOLCKER. Yes, I think we need it recorded. Okay, we will turn to domestic open market operations.

MR. TRUMAN. You might just want to confirm that the payout doesn't require a formal vote; the payout would be under this schedule and over a period of time in parallel with the others. You don't want to have to act every time.

CHAIRMAN VOLCKER. I'm assuming we won't have any other action and that it's understood that this will be paid out over the next few weeks if all goes well--if, in the combined judgment of the BIS, the Treasury, and ourselves there is suitable good faith in the Fund negotiations. Now, if we reach the point of mid-September and those things have not been completed, then we will have a real decision to make; we'll have a decision before that but a more certain--

VICE CHAIRMAN SOLOMON. We'll have a decision with no options.

CHAIRMAN VOLCKER. A more precise checkpoint--that's all one can say. Okay. Mr. Sternlight.

MR. STERNLIGHT. [Statement--see Appendix.]

CHAIRMAN VOLCKER. I don't think you mentioned the tax bill. How did you think that--?

MR. STERNLIGHT. I did [refer to it] as a plus factor, although I said that when it finally came it was somewhat overshadowed by other events.

MR. BLACK. Peter, what is the borrowing level so far this week through Tuesday in relation to our target?

MR. STERNLIGHT. Well, it has been undergoing some day-to-day changes. Through the end of the week, just taking Thursday and Friday, it was running on the low side and averaging about $175 million. Yesterday there was a considerable increase because of one large bank borrowing a sizable amount, and that brought the weekly average to $350 million. And it's fairly possible that that bank will be in again today; we don't know if they are or for how much. I was just gauging that if they were in for a similar amount today and then not in on Wednesday, and the other banks stayed in to the extent they had been in the early part of the week, we could wind up with borrowing averaging around $400 to $420 million or something on that order for this week.

MS. TEETERS. But the pattern has been continuing, hasn't it, Peter, of very low borrowing until Wednesday and then a very large increase on Wednesday?

MR. STERNLIGHT. That had been the pattern for a number of weeks, although there could be a change this week because of an effort by some banks particularly to avoid a Wednesday borrowing. If they sensed a need to be in, they tried to get in before Wednesday.

MR. RICE. Are all the borrowings coming from banks that are having trouble borrowing in the funds market?

MR. STERNLIGHT. I wouldn't say all, Governor Rice. Some of it has been the seasonal borrowing, of course, and that is partly rate sensitive. But even with the seasonal borrowers there is apparently some desire to stay within the line and not disrupt that even though 10-1/2 percent is above the funds rate of 9 percent. There was a conference call of the discount officers yesterday and it looked as though in some areas some of the borrowings were being done by banks that, while not in the severe problem category, did apparently have some limitations on their access to the funds market. And that seemed to be a factor in their turning to the discount window rather than to the funds market.

MR. CORRIGAN. Peter, where does the market think the funds rate should be? Or does it have any idea?

MR. STERNLIGHT. Well, I think there has been some surprise, just as we have been surprised, at funds trading below the discount rate. Also in the market thinking, I believe they have factored in an expectation of a further discount rate cut of 1/2 point anyway in the near term. And with that factored in, they tend to think of funds probably settling in around the 9 or 9-1/2 percent area.

MR. CORRIGAN. Assuming a further--?

MR. STERNLIGHT. Assuming a further discount rate cut, frankly.

MR. PARTEE. Peter, the classification of borrowings gets a little tricky when it's a large bank.

MR. STERNLIGHT. Yes.

MR. PARTEE. The way we do it by convention is that we consider it borrowings if it's adjustment and we consider it the equivalent of nonborrowed reserves if it's extended. I presume borrowing by a big bank would be adjustment borrowing for a long time even if it were borrowing a billion dollars or two. [Total] borrowings would shoot up. Would [the large bank portion in that total] be classified as adjustment borrowings?

MR. STERNLIGHT. If it were there for a day or two, that would be the tendency. I think if it were there in some size for even as long as a week, that would probably call for some revamping of how we looked at that level of borrowing.

MR. PARTEE. Yes, that's the question I was raising, because I inferred that while there was a [large] bank that was borrowing--I don't know whether it was strictly technical overnight financing problems--it was something that could be of longer duration.

MR. AXILROD. Well, Governor Partee, when Continental borrowed a couple of weeks ago on Wednesday, that was well within the average that we were expecting.

MR. PARTEE. Yes, that's right; it was only for one day.

MR. AXILROD. And as Peter was mentioning, if they borrow today as well as yesterday, it might raise the average for the week some. But it would be in the context of having to borrow; they were at the tail of the queue and got caught. It isn't as if they have rushed in to borrow because they didn't have real access. They have access but they are at the tail of the cue.

MR. PARTEE. I guess I was asking the question of how you would regard your path for nonborrowed reserves if you were to have a significantly higher average borrowing level than you expected because of identified problem cases.

MR. STERNLIGHT. If it were significantly higher, I think we'd have to make allowance for it. If it's for just a couple of days in this week, I think it will--

MR. PARTEE. Significant is, say, several hundred million dollars on a weekly average basis?

VICE CHAIRMAN SOLOMON. Correct me if I'm wrong, but if you made allowance for it, then wouldn't you have to categorize that borrowing by that big bank formally as emergency borrowing because the market would see a discrepancy between adjustment borrowing--

MR. PARTEE. That's right.

MR. STERNLIGHT. I don't know. There is nothing published about our reserve paths that would call for necessarily classifying it as emergency borrowings.

MS. TEETERS. Well, but we publish the borrowings, right?

MR. STERNLIGHT. Oh, yes.

MR. PARTEE. But market people looking at this rise in borrowings--

MR. STERNLIGHT. It's seen as adjustment borrowing in the public figures; but I think we could still regard it more like nonborrowed reserves if that looked appropriate to us.

MR. BLACK. Well, Peter, your handling of the $61 million that you transferred over [to extended credit and hence treated like nonborrowed reserves and] took out of [adjustment] borrowing is a situation like the one Chuck is describing.

MR. STERNLIGHT. Yes. Well, that was a smaller scale situation where the adjustment borrowing had built up and then after a merger situation that borrowing was considered extended credit and was formally moved out into the nonborrowed category.

VICE CHAIRMAN SOLOMON. The Chicago Fed publishes its weekly borrowings.

MR. KEEHN. Wednesday [levels] only.

VICE CHAIRMAN SOLOMON. Only what takes place on Wednesdays?

MR. KEEHN. Yes, [the level] at the end of that day.

VICE CHAIRMAN SOLOMON. You don't publish what takes place during the rest of the week?

MR. KEEHN. So, if they are [not borrowing] on Wednesday, there will be no way in which one could--

VICE CHAIRMAN SOLOMON. They won't catch on so quickly?

MR. PARTEE. But the average would be up, of course, for the System. Well, there is some ambiguity.

MR. RICE. The question is whether we would want to tell the market why there was a big bulge in such borrowings.

MR. CORRIGAN. We'd get a bigger bulge!

CHAIRMAN VOLCKER. This will have to be handled with a certain degree of flexibility.

MR. MARTIN. Long live ambiguity!

CHAIRMAN VOLCKER. We have to ratify the transactions if there are no further questions. Do I hear a motion?

MR. MARTIN. Moved.

VICE CHAIRMAN SOLOMON. Second.

CHAIRMAN VOLCKER. Without objection. We'll have the staff report on the economic situation.

MR. KICHLINE. [Statement--see Appendix.]

MR. ROOS. Jim, this follows the gist of your comments on [output]. I noticed that in the Greenbook you have reduced your estimate for real output growth in the third quarter from about 2-1/2 percent to 1 percent. In your analysis, was the slow rate of M1 growth over the past months--I think this has an effect on the decision we make later--a factor that led to your conclusion?

MR. KICHLINE. Not directly. Indirectly, yes, in the sense that we think it has been a factor in the interest rate outlook. Obviously, rates of growth of money, interest rate levels, and GNP are all related. I think in the short run, though, in terms of looking at what we had forecast for the last meeting of the Committee on June 30th-July 1st and the information available in the six or seven weeks since then, the forecast for the third quarter really reflects two major things. One is a different look at the inventory side; inventories just have not been declining as rapidly as we had expected. And, frankly, the key element is that final sales have been weaker. We reduced expected personal consumption expenditures in the third quarter by more than a percentage point, and that's a key element. So, in the very short run, I wouldn't associate [the change in our forecast] with M1 behavior. I would do that over a longer-run context. But in the very short run it's really that consumer spending has turned out weaker than we had anticipated.

VICE CHAIRMAN SOLOMON. We wouldn't have any difficulty with the direction of your analysis, but we are assuming an essentially flat third quarter, not as strong as 1 percent. We also are assuming a lower average federal funds rate in the fourth quarter. You're assuming 10-1/2 percent; we're assuming 8-1/2 to 9 percent. If we don't get something in that 8-1/2 to 9 percent region--if there is a significant back-up in rates in the fourth quarter--then we think the fourth quarter, instead of showing 2 to 3 percent real growth, may very well be negative. So, I think the difference is possibly in the assumptions. With your assumption [of the funds rate] at 10-1/2 percent, you still assume roughly 2 percent real growth in the fourth quarter, whereas our analysis would be that if rates back up to 10-1/2 percent, that is likely to result in a negative fourth quarter.

MR. KICHLINE. The only comment I would make is that I would agree implicitly with the view you've expressed in that the underlying determinants of economic activity in the short run, and rate behavior in particular, suggest that the economy is on the edge of a weaker performance than implied in the staff forecast. I would not bicker at all with a forecast that puts down a zero for the third quarter or minus 1 or plus 1 percent. The important point is that the way things are shaping up now, it is a small number around zero or a slight positive. It isn't a 4 or 5 percent rate of real growth; it's a weaker situation.

MS. TEETERS. Jim, did you really factor in the sharp drop in rates that has occurred in the last six weeks?.

MR. KICHLINE. Well, we tried to and we have put down our assumptions. The interest rate assumptions appear in the Bluebook and, as you know, they are trending up later this year and into 1983. One of the questions one has to ask is: To what extent does part of the rate behavior reflect concerns that wouldn't track into spending in the economy but rather a flight-to-quality, looking at bill yields, for example. That seems to me almost a sign of weakness, not something that says those low rates are going to translate into significant gains in spending later on. The one area where it is rather important--and it's an open question--is in the mortgage area. That FHA rate, as of today, is down to the 14 percent level. I think that's encouraging. But in our forecast we don't have private mortgage rates coming down that low; in fact we have them stuck in the 14-1/2 to 15 percent area, which we think is still an area that would not generate substantial levels of housing activity. So, the outcome in the staff forecast is one in which we don't believe the current levels of rates would likely be sustained, given our assumptions on monetary policy and our outlook for the economy.

MR. RICE. Could I just ask, Tony, if your forecast wouldn't expect an increase in consumption expenditures in the fourth quarter even in the face of a higher funds rate in the range of 10 to 10-1/2 percent?

VICE CHAIRMAN SOLOMON. Well, I think it's likely to be offset. First of all, we have seen that we didn't get the increase in consumer spending that we all expected.

MR. RICE. That's right. It might be lagged.

VICE CHAIRMAN SOLOMON. That was partially because there was a higher increase in savings than we expected and partially because it was offset by greater weakness in the rest of the economy than we expected. I personally feel that the more pessimistic scenario--in other words, continued weakness--is quite likely if there's a back-up in rates. And even though there will be some modest increase in consumer spending, I don't think it will be enough. Whereas if the average federal funds rate stays in the 8-1/2 to 9 percent area, I think we're likely to get the kind of real growth of 2 or 3 percent that we're talking about.

MR. PARTEE. One terribly important question is how weak is capital spending. The staff has reduced its estimates quite a bit, but the forecast is for equipment spending still to be rising by the middle of next year I believe and for the decline in nonresidential construction to be moderating by the second half of next year. The question is, if there's a major cycle there, whether it will go deeper or whether it will turn around that rapidly. And the Redbook seems very pessimistic on capital spending to me. I don't know if that represents your views or not. In Atlanta you are looking at one set of exceptions; you saw a little strength recently.

MR. FORD. Yes, just in a few industries. But in real terms, taking out price changes, our regional economy is flat, which is better than in the rest of the nation.

VICE CHAIRMAN SOLOMON. Anecdotally, what I hear in New York is very pessimistic on capital spending. Just last week a few businessmen told me they had made further cutbacks in their planned capital spending, and those plans had already been quite low.

MS. HORN. In the Fourth District, where we have a lot of capital goods industries, the outlook for capital spending has gotten worse in the last couple of months, I would say. A couple of months ago when you asked inventory questions of these people, they would say that they had really reduced inventories to bare bones and were not sure how they could continue operating with these inventory levels. Now they are evaluating those same inventory levels differently, saying that they can do business for the foreseeable future with those inventories.

MR. BLACK. I wonder if a lot of the difference we see isn't that the businessmen we're talking to are not assuming as low a rate of inflation as Jim and his associates have assumed here. If they were assuming that, I think we'd see a much stronger capital picture. And if we do obtain that, I would think long-term rates would have to come down some, and that ought to have a salutary effect on capital spending. My guess would be that next year might be a little stronger, but heaven knows it could be a lot weaker.

MR. KEEHN. Chuck, in the Midwest, most of the companies are operating at such a low level of capacity that there is just very little enthusiasm for any capital expenditures. Until that begins to pick up in some material way, we will not see an improvement on the capital expenditure side.

MR. PARTEE. I get the impression that orders are falling in Chicago. I don't know.

MR. KEEHN. Yes. Many of the industries are continuing to experience a decline. I think, certainly, the rate of decline has slowed but there is still for some industries a perceptible continuing decline.

CHAIRMAN VOLCKER. Mr. Axilrod, why don't you give us your blessing and we'll go not to lunch but to a donut break.

MR. AXILROD. [Statement--see Appendix.]

CHAIRMAN VOLCKER. I think we'll go for a little recess.

[Coffee break]

CHAIRMAN VOLCKER. Well, I don't know what I can add to Mr. Axilrod's astute dancing around the issues. We're in a very sensitive period, not just economically, but in terms of the markets and interpretations and in fact concern--and I'm afraid to some degree justified concern--about the stability of the banking system. I am sure that this is a time to be delicate and sensitive. How we express that and how we approach it is what is at issue. Very technically, as Steve mentioned, we're in one of these phases when it's hard to set a reserve path with great certainty because we're on the margin of losing touch with rates in the market. This problem occurs if we get extraordinary borrowing from some particular banks that have their own problems, and that can't be considered borrowing in the ordinary way we usually consider it. Just how it should be considered is a little hard to tell in advance, I think, before we see it and before we see the timing and the amounts. But it's another complication in [the way of our] being mechanical in this process at the moment. I don't think we can afford to be overly mechanical.

I would just make one further comment with regard to the growth in the money supply in particular. Considering that we're in the middle-of-the-quarter meeting, my own bias, which I've expressed before, is not to change these numbers unless there's a strong reason for changing them. If there's a clear-cut reason for changing them, we should change them, but fiddling around with a half percent or so on the growth rates is hardly worthwhile. With that much introduction, who would like to make some astute comments as opposed to ordinary comments?

MR. PARTEE. That's going to create total silence!

VICE CHAIRMAN SOLOMON. I'd like to make a straightforward comment; it's not very astute. I think we ought to go for alternative A, with maybe a $300 million initial borrowing assumption instead of the $250 million. And we ought to be quite sensitive to the fed funds rate in the next few months. I don't think I have to go into my reasons why. We're in a very delicate stage not simply because of financial fragility, but with regard to the question of whether there will be some recovery at all. I think we ought to take advantage of your Humphrey-Hawkins testimony where you said we want to M1 growth to come in around the 5-1/2 percent [upper end of the range] and will even tolerate something over that under certain conditions. Alternative A still puts M1 around the top of the range. And even though I realize that, obviously, if the money supply bulges in the fourth quarter, we will then have less room than if we adopted alternative B now, I still think the next couple of months are quite critical. And maybe we'll be lucky on the money supply in the fourth quarter.

CHAIRMAN VOLCKER. Let me just make a couple of technical comments, so we don't have to keep repeating it or raising questions about it. The present [short-run] targets are about 5 percent [for M1] and about 9 percent [for M2]. Steve, under alternative A, had put in 10 percent for M2. At this moment in time [M1] is running below the 5 percent, but that target is for the quarter as a whole and it's not clear it is going to run below 5 percent for the quarter as a whole. That depends upon what we think is going to happen. If September continued more or less the way August is going so far, I suspect growth would be up to 5 percent. But we are clearly above the 9 percent so far on M2. It's a matter of choice here. We have a directive now that says immediately in the next sentence that somewhat more rapid growth would be acceptable [depending upon certain developments]. So, I think one could interpret this M2 running a bit high as basically being in line with the existing directive given that second sentence.

MR. MORRIS. I think M2 is being distorted by the fact that when interest rates go down, it pays the wealthy investor to move out of market instruments into money market funds.

CHAIRMAN VOLCKER. It might be, to some extent; and nobody knows just how much. But that may just be some special case of a more general interest in liquidity and for locking in some of these rates while they last. All I'm saying is that I'm not sure we have to raise the 9 percent to 10 percent in the light of that next sentence that is already in the directive. I'm just making a technical point.

MR. PARTEE. Well, I agree with Frank that there probably is some money moving from the market into M2 forms, although it may cease because, after all, these stocks that have been bought recently have to be paid for. But in addition, of course, the staff makes the point that consumption is weak relative to income. And that is going to show up somewhere. Is it more likely to show up in M2 forms than anywhere else, given the fact that we're talking about a broad base of the consuming public and so forth? I agree with Tony that the fact that we hold to 5 percent as the M1 target doesn't mean we are going to get it. Indeed, we really thought last time that it would be hard to keep M1 growth down to 5 percent. Now we think it might be hard to have it up to 5 percent. We don't know what is going to happen. Let's face it. But it would seem very strange, given the economic circumstances in the past six or seven weeks since the last meeting, to cut our target growth rate for the third quarter because the economy appears weaker than it was perceived as having been seven weeks ago. I think that was said by everyone who spoke and certainly was the thrust of the Redbook and also the Greenbook and your comment, Tony, on the New York projection. Why in the world would we cut the growth rate in those circumstances? So, I agree with you. I think it's best to hold [to our current targets].

VICE CHAIRMAN SOLOMON. The additional point I'd like to make, which I've touched on briefly, is that I'm really concerned about a lot of movement in the fed funds rate. We don't want to see too much, if any, back-up. Also, on the other side, it would be quite damaging psychologically if we let the rate go too low and then had to be forced to see some back-up in the fourth quarter. I don't know how to handle that. All I'm saying is that we ought to be very sensitive this time.

MS. TEETERS. Well, there is a way of handling it, and I think Steve mentioned it. And that is to keep our eye on the excess reserves. If excess reserves begin to pile up, we could deviate from the path even though [that would mean] not putting all the reserves that we intended into [the banking system]. We would operate fairly flexibly to keep the rate either from backing up or from dropping precipitously. That's really the key to this, Tony.

MR. PARTEE. You're not proposing that we narrow this [fed funds rate] band?

VICE CHAIRMAN SOLOMON. I don't know what I'm proposing. I'm just saying that--

MR. RICE. No, he's just saying these [unintelligible] words.

MR. PARTEE. We used the whole 5 point range last time, by the way.

MR. MORRIS. I'd like to suggest that we have a consultation if it appears that in following this directive the Manager would have to move the funds rate above 10 percent. I'd preserve the form and keep [a fed funds band], but as we have done in the past when we planned to utilize the band or if there was such a possibility, we would have a consultation. I think to move the rate above 10 percent in the near term could be very destabilizing.

MS. TEETERS. But we don't want it to drop out of bed either.

MR. MORRIS. No, that's right.

MR. ROOS. Mr. Chairman.

CHAIRMAN VOLCKER. Mr. Roos.

MR. ROOS. I find myself in the pleasant posture of agreeing with Tony and the others in terms of the ultimate objective. I think we should avoid a continuation of slow money growth. But I'm a little concerned about the thought of our attempting to lean against a further drop in interest rates because I think that would imply a further slowing of money growth. Money has grown exceptionally slowly over the last five months and, at the risk of analyzing something in a little different manner than some of you do, our experience prior to every recession that we've had since World War II is that when money has grown below its trend rate for two or more quarters it inevitably leads to a softening in the economy and to a recession. Even a rather unsophisticated set of eyes such as mine can see that this has been the experience. And although none of us knows what the future holds, I have a great fear that if money is permitted to grow slowly for several more months, we could have a serious weakening in the economy at the end of this year and into the early part of next year. If that were to happen, we could have a revitalization of the criticism that we have been too tight. So, I would certainly favor alternative A, but I would not be quite as concerned as one or two others have indicated about acting to prevent a further drop in the fed funds rate. I think doing so would exacerbate the undershoot of growth in the narrow aggregate.

CHAIRMAN VOLCKER. Governor Rice.

MR. RICE. Mr. Chairman, I don't want to risk disagreeing with anything that has been said up to now. I certainly want to see interest rates low, and for that reason I'm inclined toward alternative A. But at the same time I want interest rates to stay low. And I worry that if we follow alternative A in the face of the GNP forecast that we have, the implication is that interest rates are probably going to go back up in the very near future. There are going to be upward pressures. In order to keep interest rates down, we're really going to have to increase money growth substantially above the target range. Now, I wonder if we want to do that. If we increase money growth for the year to above, say, 6 percent, I just wonder if we are willing to accept such an outcome. If we are, then fine, alternative A is a good way to go. If not, then it seems to me that we're going to have a fairly strong back-up in rates. And the effect of this I do not welcome. Since the difference between "A" and "B" seems to me to be unusually narrow this time, I could go just as easily for alternative B. But I am prepared to go along with alternative A. It's rare that I'm in such a happy position as to choices. But, I really want--

VICE CHAIRMAN SOLOMON. Emmett, alternative B gives you the back-up immediately.

MR. RICE. Well, I'm not so sure about that at all.

CHAIRMAN VOLCKER. Well, it depends upon how we play it. Mr. Balles.

MR. BALLES. Well, on this interest rate matter, I guess it's time for a little school of contrary thinking. I don't look on it as trying to explain why interest rates have come down so precipitously and dramatically since early July. I think the mystery is why they didn't come down a heck of a lot earlier. If one looks back over decades at the relationship in this country between the inflation rate and interest rates, particularly short-term rates, there has always been a close correlation with only a short lag up until this recent episode. So, I look on this recent decline as being a long overdue decline because we have had dramatic success in getting the inflation rate down and interest rates, particularly short rates, just didn't come down along with it. The relief that we are now getting on the interest rate front is desperately needed from the standpoint of all kinds of businesses and depository institutions. I guess I would worry later on if, as, and when interest rates begin to go up again. And I would certainly want to take advantage of opportunities to nudge them down and to keep them down right now because of what I consider to be the growing cumulative damage being done to all kinds of businesses and depository institutions by this high level of rates. But I'm not at all convinced personally that interest rates are necessarily going to go up just because business may strengthen a bit. That would be a normal cyclical pattern. But we've had such an unusual relationship between the depressed level of economic activity on one hand and a very high level of real rates on the other that I don't think a rise in interest rates is foreordained by any means. That may be wrong, but that's the way I feel about it right now.

We do have in the short run a perplexing problem of monetary control with the discount rate clearly out of touch with open market rates. Often in the past when that has happened, we've had somewhat of a loss of monetary control; it can lead either to overshoots or undershoots, depending on which historic episode one looks at. If we tried arbitrarily to peg the federal funds rate in some narrow band, there would be a couple of alternatives for dealing with this. One would be just to lower the discount rate dramatically, but that has announcement effects that might be quite unfortunate if the public felt that was a signal that the Fed was caving in and that we were going to start monetizing these big government deficits and have a sustained period of monetary acceleration. Another alternative, instead of bringing the discount rate down too sharply, is to bring it down in a series of gentle 1/2 point moves; I'd be inclined to do it that way myself. But I would also accompany that by a widening of the federal funds band. This is where I guess I'm going to be rather radical now: As long as we have the problem that we have right now, I would like to see the funds range widened from the present 5 points to about 8 points. Specifically, in this current situation, while I'm in favor of the monetary specs of alternative A, I would like to propose that we consider widening the funds rate band to 4 to 12 percent instead of the 7 to 12 percent proposed in the Bluebook. That would admittedly get us into a situation where the funds rate moves over a much wider area than the market is used to. We'd have to try to educate the market and explain to them why we're letting that happen. But by bringing down the discount rate gradually as well as widening the funds rate band, we can keep money under control and prevent either sustained overshoots or sustained undershoots.

CHAIRMAN VOLCKER. Governor Martin.

MR. MARTIN. I think the arguments for alternative A are compelling. I note that the staff in its discussion of its projections, particularly for the third quarter, indicated that there is some uneasiness attached to the 7-1/2 percent nominal GNP number. We have question marks on the domestic investment projection, on the residential structures projection, and on auto sales on the down side. That has implications as to which of the two alternatives [to choose]. I would agree that the two alternatives are rather narrow in their band. The weaknesses that we have been noting both in the Redbook and in our own discussions here today affect expectations and, therefore, I believe the actions taken by us and noted in the markets will have a different interpretation from what they would have had a short time ago. I think market participants are, as we are, much more aware of the illiquidity of major corporations and of the question marks over the banking system, as well as the general weakness structurally of the world economy for that matter. Therefore, I believe we have a little more action space, perhaps, than we've had before. Plus, I will reiterate the comment I made at the last FOMC meeting. It is that we have a responsibility for the stability of the banking system, which we are meeting. Admittedly, there has been a comment or two from the political side with regard to the way to do that. But given this narrow set of alternatives, I would go toward "A" rather than "B," in part to preserve the climate in the markets that has provided a little more action space. Therefore, for the borrowings I would lean toward a $350 million number, a rather larger number with a pretty large standard deviation around that. We need flexibility in this particular six-week or eight-week period as we seldom need it. And I think it's important to have the ability to alter many of these variables in our targeting over this period. So, I would strongly urge "A" with a $350 million borrowing number, plus or minus.

CHAIRMAN VOLCKER. Governor Wallich.

MR. WALLICH. Well, I certainly agree that we need to do all we can to help the economy and to help the markets. At the same time, we have to look ahead. What we do now will affect the economy with a lag anyway. I don't think we've seen the end of the effects of the tax cut. I don't see any reason to change the basic projection even though things are coming in more slowly than one would have thought. I think we are in some danger of doing what we have done very often at the depth of a recession, at the trough, which is to stimulate more strongly than turns out in the course of time to have been wise. Now, we ought to avoid a rise in short-term rates or reversing the present low level. To me that suggests not pushing for a lower level at this time. I'm not too concerned about lowering the M1 path for the three-month period that we're in from 5 percent to 4 percent because even that still leaves us almost exactly at the upper end of the 5-1/2 percent M1 range [for the year]. And M2 and M3 are very high [in their ranges] anyway, although they have particular reasons for being that way. I also want to remind you that, historically, a period of relatively low interest rates leads to an increase in money growth some months later, which is the last thing we need to have happen at the end of this year or early next year.

I am troubled by the gap between the funds rate and the discount rate. A funds rate below the discount rate is always taken as a signal that there ought to be a cut in the discount rate. But all that happens is that the funds rate falls some more and the signal remains in existence. I would, therefore, prefer a higher borrowing level to reduce that gap or eliminate it. One could offset the consequences of that, in order not to get tightening effects, by lowering the discount rate. There must be some drop in the discount rate that would offset a moderately higher borrowing level. I'm not thinking of anything sensational, say, $400 million perhaps.

Finally, as to the longer-term rate of money growth, I would like to point out that if you look at the projections in the Greenbook throughout 1983 there is hardly a quarter over 8 percent for nominal GNP; it runs from 6 to about 8 percent. In other words, with [growth] at the upper end of our existing targets and really very moderate increases in velocity, we'll be able to accommodate that rate of [GNP] growth. Now, this may be optimistic with regard to the inflation forecast implicit in these very low nominal GNP growth projections, but that seems to be at least a possibility. So, I would vote for something like "B" and particularly a $400 million borrowing level. But I would predicate that on the possibility of reducing the discount rate.

CHAIRMAN VOLCKER. Mr. Corrigan.

MR. CORRIGAN. I'd start off with the point that if we find that some of these financial things we're worrying about begin to come a little more unglued, obviously, a lot of this somewhat technical discussion about borrowing levels and all the rest will have to go by the boards. But abstracting from that, it seems to me that one of the key questions implicit in what has been said already is whether or not interest rates are at sustainable levels for, say, a few months or quarters. I have some concern that they may not be. And it seems to me, in view of all the financial strains and concerns, that one of the things we have to be particularly sensitive to is the possibility of another whipsaw effect in the markets where, despite our actions, we find interest rates rising again. I'm not sure how to do that. My own view on the economy, which I think is relevant, is that with the general range of rates that we're talking about I would still look to a modest recovery in the fourth quarter out into 1983, and maybe even a recovery that is a bit stronger than what the staff has in the Greenbook. But, certainly, I'm a little more cautious in that statement than I would have been even a month ago.

As to the money supply numbers, I must say, like Governor Rice, I don't have a strong preference one way or another between "A" and "B." And, Steve, if I'm reading that table on page 13 in the Bluebook right, I think it suggests that building off either alternative we're looking at a growth rate of, say, 5 or 6 percent in the fourth quarter, which still would get us to around the top of the range for this year. Is that correct?

MR. AXILROD. That's right.

MR. CORRIGAN. Well, that just reinforces my view. I don't have a strong view; I could go with "A" just as easily as "B." I do think that a critical question in the short run is where the funds rate is and where the borrowings are. Again, just because I am perhaps a little more sensitive to the sustainability of the current general pattern of interest rates, I would probably lean toward a borrowings level in the $350 million area. I don't want to sound too precise here, but I'd probably be more comfortable with the funds rate in the 9-1/2 percent area right now than I would seeing it below 9 percent. But, unless we're very lucky and the money supply behaves exactly the way the Bluebook suggests so that the nonborrowed reserve path behaves exactly the way it suggests--neither of which will happen--we have a Catch-22. If money is stronger, interest rate pressures will build; and if it's weaker, the tendency will be for us to adjust the nonborrowed path at some point, and that would aggravate the problem that Governor Wallich spoke about in terms of the discount rate and the funds rate. The only way I can see out of that is to lower the discount rate and try to nudge up the federal funds rate at the same time. I'm not sure how to produce that result, but it seems to me that that's the result we want.

VICE CHAIRMAN SOLOMON. Well, then, would you go to $400 million on the initial borrowing?

MR. CORRIGAN. I might shade it up.

VICE CHAIRMAN SOLOMON. But then what happens if you get a bulge in the money supply in the next couple of weeks and the Board feels inhibited about doing a discount rate cut?

MR. CORRIGAN. That's my Catch-22. At the moment, I am suggesting that I think the probabilities are that we are going to be on the other side of the Catch-22.

CHAIRMAN VOLCKER. Mrs. Teeters.

MS. TEETERS. Well, I would go for alternative A. I'm really very reluctant to see rates go back up because I think people need the relief all of us have been talking about. I'm basically more concerned about the technical operation of the Desk. It seems to me, as I mentioned earlier, that we have to be extremely flexible and look at all of our indicators to make sure that we don't bounce the funds rate down to zero or accidentally bounce it back up to 15 percent. So, I would pay much more attention to where the rate is rather than mechanically supplying nonborrowed reserves or trying to hit a target of money supply growth. That doesn't mean that I would suggest either increasing or decreasing the band on the federal funds range, but it seems to me our focus should be on that rate. Obviously, I would like to have a somewhat lower rate, but I don't want to see rates drop as precipitously as they have in the past six weeks. So, a little change in our focus from reserve provision and money supply growth [to a] smooth constant rate on federal funds seems to me more important at the present time.

CHAIRMAN VOLCKER. Mr. Black.

MR. BLACK. Well, Mr. Chairman, now that we're back inside the target range for M1, I think we ought to concentrate a little on trying to keep it there. I recognize, as everyone does around the table, that there are severe risks inherent in the situation and that we need to reverse the declines that we have had in the money supply in May, June, and July. You can go back even further than that in fact to February when we had pretty weak performance. But we also ought to take account of the possibility that this very rapid decline that we have had in the federal funds rate in recent weeks could well give us more growth in M1 than we would like to see. Alternatives A and B don't differ a lot numerically, as several have pointed out, but I would much prefer "B" simply because it states that we have in mind staying within the target range, and I would hate for the record to show that we were aiming at something above the range. I'd much rather go above the range than for us to say that we are trying to do that. I'm as anxious as anyone here to see a permanent decline in interest rates, but I have to confess that the sharp drop in the federal funds rate in the last six weeks does cause me some concern. If you look back at the post-October '79 period, there have been three distinct periods where we had a pretty rapid drop. One was in connection with the credit control program and is probably an invalid [comparison]. But in the other cases we had a pretty rapid acceleration in money growth after that. So, I think it's possible that we have set in motion forces that may be adequate to give us "B," or for that matter "A," and maybe even something more than that. So, on these grounds, I'd feel a little better if the federal funds rate held or maybe even backed up a bit until we get a better idea of how the impact of what we have done will show itself. So, like Emmett Rice and Steve Axilrod, I would say that a small back-up now probably would be preferable to risking the possibility of a larger back-up later on. I think $350 to $400 million might be the proper borrowing range on the assumption that the discount rate remains unchanged. But if there is a strong likelihood that the discount rate will be reduced in the immediate future, then I think we ought to have a little higher borrowed reserve target.

CHAIRMAN VOLCKER. Governor Partee, you already have had one bite at the apple.

MR. PARTEE. Well, I didn't say anything much about rates and I do think this rate question is very fundamental and important. Certainly, one could be sympathetic with the view that Bob just expressed, or Tony, in light of the fact that the staff projection is that rates are going to be quite high over the next year. Therefore, if one really believes that the funds rate is going to be well above 10 percent throughout 1983, the farther it drops now, the more it is going to have to snap back later. But the question is: Is that right? I don't know if it is or not. The fact of the matter is that long rates are still plenty high in terms of having a restraint on the economy and, indeed, if they dropped another point or two, they would still be high relative to projected rates of inflation. And short rates are behaving very unusually because liquidity preference is so strong. Now, if we try to keep those short rates from declining by holding the funds rate up and liquidity preference is there, we can only do it by destroying reserves and having a larger reduction in the money supply than would otherwise occur. And it seems to me that that's the wrong policy to follow. I also don't know about the similarities with past experiences, Bob. I sense right now that there has been one really big change in the behavioral characteristics of the economy, namely, that banks aren't lending. They are very reluctant to lend at any rate to a great many customers. And if that's so, I'm not so sure that we'll get a surge in loans and the reliquification that would occur with the surge in loans, given bankers' attitudes and concern about their own balance sheet positions. So, I wouldn't go--

CHAIRMAN VOLCKER. I'm not so sure about that observation. I'm not sure about that change.

MR. PARTEE. I feel that way. I feel that the banks are pretty scared.

CHAIRMAN VOLCKER. I think they're scared, but whether that is translated into not making loans, I'm not so sure.

SPEAKER(?). I've heard that too, Chuck, from businessmen in our area.

MR. PARTEE. I wouldn't go as far as John Balles has suggested to a really major shift. I have some sympathy with his view, but I wouldn't go that far. I do believe that we ought to be prepared to see rates go lower because we can't see what the future is going to hold. And we ought to see to it that we continue to have some money supply growth; in that respect I agree totally with Larry Roos. To have very weak money supply growth or a decline at this time would risk a second decline in the economy and we wouldn't survive that as an institution.

MR. BLACK. I'm very much opposed to that happening, Chuck. I just was suggesting to Paul [that we wait] to see what was going to happen. If what you think will happen [does occur], I think we ought to let rates come down.

MR. PARTEE. So, I think we ought to have a range and we ought to be sensitive to changes, but we ought to use the range if we need it.

MR. BLACK. Well, I don't really disagree with that. I just think we ought to wait a while to see what is really coming.

MS. TEETERS. Are you talking about the interest rate range?

MR. PARTEE. Yes, the 7 to 12 percent.

CHAIRMAN VOLCKER. Mr. Keehn.

MR. KEEHN. Between the two alternatives, I certainly am emotionally pushed toward alternative A because, given the circumstances in the Midwest, I think we want to do everything possible to encourage and sustain lower interest rates and to try to improve the outlook for the recovery. I have to admit that I am far gloomier than the staff forecast with regard to the outlook for both this year and on into next year. Having said that, I find the shift in the implied growth rate for M1 between now and the end of September under alternative A just a little abrupt. And if we run into a period during which M1 begins to grow, I wonder whether we won't have to react in a way that would cause rates to back up. So, though [the difference between] the two alternatives is fairly narrow, I might come down about in the middle between the two, just to split a fine hair even finer. I'd suggest that M1 growth of maybe 6-1/2 to 6-3/4 percent would be appropriate so that we can see how it goes between now and the end of September. With that a fed funds range of 7 to 12 percent and a borrowing range of $300 to $350 million would be appropriate.

CHAIRMAN VOLCKER. Mrs. Horn.

MS. HORN. I come out somewhere toward alternative B myself. It seems to me that the basic underlying economic problems of inflation and the budget and crowding out and so forth are still with us, though some of them perhaps have moderated a bit. We do face a weak economy--and those of us from the Midwest face a particularly weak one--for which lower interest rates are necessary. But we have to have low interest rates for the right reason if we're going to stay in the range and stay in it for the length of time that would be helpful to our economy. I am also concerned that we as an institution need to have a steady measured response to the weak economic growth, and I am concerned about leaving ourselves enough room that we don't have to take extreme actions in the future in response to a surprise or an unpredictable increase in the money supply. So, I would come down on the side of those who are for alternative B or something more toward it, although at this moment the difference between "A" and "B," as a number of people have said, is not so significant that I would have to go as far as alternative B.

CHAIRMAN VOLCKER. Is there anybody else who wants to say anything? Mr. Ford.

MR. FORD. Yes, I come out leaning toward "B," too. While I sympathize with the notion that we have had three months of weak M1 growth and that we certainly don't want to let it fall out of bed for another whole quarter, the trend seems to be toward its moving back up. And just for the pure cosmetics of it, as one other speaker mentioned, since there is so little difference between the two alternatives why not let the market know when they get the news on this--whenever that is--that we're shooting to come in within our [monetary growth] target at the end of the year? There is so little difference between these that I think our credibility is worth going for the "B" alternative because it does show us allowing money to grow by a reasonably respectable rate over the rest of the year should we maintain this policy, which is a point Larry and others have expressed concern about. It would still leave room for interest rates to moderate, I think; I certainly wouldn't expect voting for "B" to result in a huge jump in rates from their present levels because in my mind, as John Balles mentioned, this great decline is long overdue. And I'm always for widening the [fed funds rate] band so that we do focus on trying to steady our performance and make ourselves more believable and predictable. So, I come out for "B" with a borrowing range around $350 to $400 million. I'd like to see the fed funds range widened and I'd like to see the [Board of] Governors vote to lower the discount rate before we leave the room.

CHAIRMAN VOLCKER. That's unlikely.

MR. RICE. I was going to ask you how you reconcile this--

CHAIRMAN VOLCKER. Anybody else want to say anything? It's up to me?

VICE CHAIRMAN SOLOMON. Some people haven't--

CHAIRMAN VOLCKER. I think we have a problem that is not very amenable to a Committee decision that lasts for six weeks. I'll say that first of all. On these monetary growth targets, in substance, I don't care. I think either of these two sets of numbers will make no difference, virtually, in what we actually do. On balance I'd just prefer to leave the directive as it is, which I guess is a compromise between "A" and "B," with the next sentence which allows us to go above [the target] on M2. If we were publishing this tomorrow, I would be a little hard pressed to explain why we put in a lower money supply target this month than we had last month. We are not publishing it tomorrow, so maybe that's not totally persuasive, but we are within the limits of the growth targets anyway. I don't think this argument depends upon how much we're in, but a 5 percent M1 leaves us within the target in this quarter, doesn't it, Steve?

MR. AXILROD. Well, by September M1 growth would be maybe a tenth above, at 5.6 percent.

MR. RICE. The chart shows it a little above.

CHAIRMAN VOLCKER. I didn't even look at the chart. I just thought we set it last time so that we would be within by September. It's 0.1 over?

MR. AXILROD. No, it has always been--

MR. MARTIN. It's 0.1 above. What's wrong with that?

MR. PARTEE. And we said, of course, the top of the range in the testimony.

CHAIRMAN VOLCKER. Boy, that's pretty close figuring!

SPEAKER(?). That's what we are doing.

CHAIRMAN VOLCKER. But I don't care a lot about that. I think how we manage ourselves is quite important in these coming weeks. Let me state my position very simply. I would be totally unable to defend a policy on our part that brought the federal funds rate up to 11 or 12 percent in the coming period. I would be very hard pressed to justify in my mind a pronounced downward shift in the federal funds rate in the near term from where it is. I think we'd have the gold price rising--it's already rising--and an awful lot of commentary about what the heck the Federal Reserve was doing in terms of doing a real somersault. We already get that commentary. I think it's unavoidable and it would damage us.

What we are saying in substance, I hope, is that if we don't get a continuing growth in the money supply in coming weeks, interest rates probably should go down some. I should take out the "probably." If we literally didn't get any growth in the money supply in coming weeks, we'd presumably continue to take some combination of measures on reserve paths and discount rates that would produce somewhat lower interest rates. If the money supply came up rapidly enough to reach 5 percent so that we get a pretty big increase in September, which raises some of these problems that people have been talking about as to where we go then, I don't think we would get any further decline in interest rates and we might get a little increase in market rates from their present level. I think basically that's the way we ought to play it. If money growth came in distinctly weak, we would ease up by some combination of measures, which would produce a little lower interest rates. If it came in as strong or stronger than 5 percent, I would suggest that we probably would get some backing up of short-term rates through some combination of higher borrowing figures and not reducing the discount rate, or maybe just reducing it once instead of twice as we might do in other circumstances. I think that is what the decision ought to be in substance; we can look at it again in a few weeks.

I, frankly, cannot live in these circumstances, given what is going on in the money markets, with violent moves in short-term rates in either direction. It would just be so disturbing in terms of expectations, market psychology, and fragility that it's just the wrong policy, period, during this particular period. Again, that is not inconsistent with more moderate movements in either direction depending upon what happens to the aggregates. But I just think we'd end up in sheer confusion--more than confusion; we'd end up with an atmosphere in markets that deteriorates rather than improves things. I don't know how to word all this, frankly, but what I would be inclined to do--let me experiment here a bit--is to take out that last sentence entirely and replace it with something like this: "The Chairman may call for Committee consultation if it appears that pursuit of the monetary objectives and related reserve paths during the period before the next meeting is likely to be associated with unusually volatile conditions in credit markets." That covers a multitude of sins. The reason I'm reluctant to put a federal funds rate range in there is that I don't think it's realistic--I just speak for myself--on either end of the range, particularly the upper end.

VICE CHAIRMAN SOLOMON. The realistic range would be 7 to 10.

CHAIRMAN VOLCKER. Yes, that's right.

VICE CHAIRMAN SOLOMON. And if we don't want to show that narrow a range--

CHAIRMAN VOLCKER. We could put a narrow range in there, but I'm not sure that people want to do that. But, in substance, I think for the weeks immediately ahead that is about where we are.

MR. BLACK. What you're really saying is that on the old procedures you would favor a money market directive. I think that's essentially what I said, really.

CHAIRMAN VOLCKER. That is correct. But how we lean would be guided by the money supply, assuming that something drastic isn't going on in the rest of the market.

MR. ROOS. The sort of wording we had in the directive in this previous period would have meant much more active reaction to what has happened. In other words, what happened in the last week involved rather volatile interest rates, even though they were volatile in a pretty good direction.

CHAIRMAN VOLCKER. Well, I'm not very happy about the speed with which they went down, frankly, because I think it raised some questions. But it was at least in the direction that was acceptable. I'd be more disturbed if they suddenly went bouncing up again. Now, when I say suddenly bouncing up again, I'm not talking about the federal funds rate going up [a little]. Where is it now? It is below 9 percent now. If it went up 1/2 or even 1 point, particularly if the money supply were rising, that wouldn't bother me.

MR. ROOS. Would the changed wording cause eyebrows to rise within the--?

MR. FORD. Yes, how is it going to be read when this--?

MR. ROOS. That's what bothers me, whether it would be read as a signal of a return to stabilizing interest rates.

CHAIRMAN VOLCKER. I think it's going to be read--

MR. PARTEE. It's giving the Chairman all the authority; that is what it amounts to. It gives the Chairman all the authority; I think the Committee renounces its responsibility if it accepts such a thing. Given the two choices, I would much prefer 7 to 10 percent [on the funds rate range].

MR. MORRIS. Yes, I don't see anything wrong with setting a 7 to 10 percent range specifically. It's still 300 basis points. It's not cast in stone that we have to have a 400 or 500 basis point spread, and it seems to me foolish to have one that we don't plan to use.

MR. FORD. Well, what would you have done if we had set a 3 percentage point range six weeks ago when it actually moved more than that?

MR. PARTEE. We would have gone through it.

MS. TEETERS. We would have gone through it, which we did. We went through the range.

VICE CHAIRMAN SOLOMON. We would have had a consultation.

CHAIRMAN VOLCKER. We would have had a consultation and gone through it. That's right.

MR. PARTEE. Yes.

MR. WALLICH. I think we're giving altogether too much emphasis to the range. It's the intention that lies behind the range that matters. I understand perfectly well what the intention is and I think it's the right intention at this time. Maybe Chuck's problem could be met by the Chairman declaring his intention to call on the Committee if these conditions arise.

MR. PARTEE. Well, the wording you have there, Paul, just suggests that we have in mind these monetary aggregates but that what we will do is run the market according to what you think credit conditions ought to be like. That's what it says, I think, or it's very close to it.

CHAIRMAN VOLCKER. I don't.

MR. PARTEE. I just don't think the Committee ought to do that.

CHAIRMAN VOLCKER. Well, I don't understand your point, but I'm in a somewhat different position than you are in understanding perhaps. What it is meant to say is that we're going to conduct operations so that there isn't undue volatility in the federal funds rate but that the direction in which the funds rate will go in the first instance is determined by developments in the aggregates. I think in substance it means something like 7 to 10 percent probably.

VICE CHAIRMAN SOLOMON. I think we have three choices: We can say 7 to 10 percent; we can say 7 to 12 percent with an understanding that when the rate is outside 7 or 10 percent the Chairman will call a consultation; or we can take his language about unusual volatility.

MS. TEETERS. Or we could take both because I think some of the volatility is going to come, say, from extra borrowing by Continental Illinois or Chase or something of that sort. And it would signal to the market that we're going to be there as the lender of last resort.

CHAIRMAN VOLCKER. That, I think, is a little different question. That goes to how we establish the borrowing level more immediately than the federal funds rate. On the borrowing level, I'd be a little reluctant to move it up very much unless and until we reduce the discount rate. Then I think we might do it and try a very modest snugging to offset the downward impact of a discount rate change. I would not want to do it tomorrow, have the rates go up, and then reduce the discount rate--

MR. ROOS. Isn't it desirable, with things at least presently going our way, in effect, to word this directive much like previous directives? In other words, isn't it desirable to avoid anything that might imply any [move away from such a directive]? I think the world today thinks that you have done a great job since '79 in getting us where we are right now and I just--

CHAIRMAN VOLCKER. A small part of the world?

MR. ROOS. My side of the world.

MR. BLACK. People in St. Louis!

SPEAKER(?). If not 100 percent of the businesses.

MR. MARTIN. Not the Democrats, that's right.

MR. BALLES. Did you see Lindsey Clark's article in The Wall Street Journal this morning?

SPEAKER(?). Yes.

MR. CORRIGAN. That should really make you worry!

MR. BALLES. It leaves the Fed alone.

CHAIRMAN VOLCKER. What did it say?

MR. BALLES. It says, in effect, "Leave the Fed alone and don't mess around with them. They're doing a great job."

MR. MARTIN. Clark said that?

SPEAKER(?). Yes.

CHAIRMAN VOLCKER. Specifically, what I would do is to leave the first two sentences in the present directive as they are. In fact, I'd put a few words in there like "continues to seek" and "as indicated" or something.

MR. MARTIN. Yes.

CHAIRMAN VOLCKER. And I'd leave out the next sentence, which is crossed out in the draft. Then my proposal was to replace the last sentence with something like what I had suggested. Now, the nearest equivalent to that, I think, is just leaving the same sentence but putting in 7 to 10 percent, which conveys the same flavor. I think either way of doing that--

MS. TEETERS. Wouldn't narrowing the range give some stability to the markets, indicating that we weren't just going to let the rate fluctuate all over the place? I think there's a distinct advantage to doing that.

MR. WALLICH. They will only know that [in October].

MS. TEETERS. Yes, in October. That's true.

MR. RICE. Of course, they will say we have starting watching interest rates again.

MS. TEETERS. That's all right.

MR. BLACK. Mr. Chairman, there has been some speculation, incorrectly, in the papers that we have moved away from aggregate targets to interest rate targets. So, I would feel a bit like Chuck does on that, although I agree with what you want to do. So, maybe 7 to 12 percent with consultation at 10 percent or something like that [is the way to go].

CHAIRMAN VOLCKER. I don't like this idea of 7 to 12 percent, which gives a public impression that is different than the private one. I'd have a little difficulty defending it. I don't know as it has become a big issue of why we said 12 percent in the first place on the credit conditions.

SPEAKERS(?). Yes.

MR. PARTEE. This says consultation. These [ranges provide] test points for consultation, as indicated in the very first part [of the sentence]: "The Chairman may call for Committee consultation...."

MR. MARTIN. Well, that [implies] 10 percent, not 12 percent.

MR. PARTEE. Yes. So, I don't see quite how we can say 7 to 12 percent except that if it's over 10 percent there should be extra consultation.

MR. BLACK. That does present a problem. In view of these articles that have been appearing--I'm just picking up on Larry's point, I guess--I'd rather hate to change the wording right now.

MR. PARTEE. Well, I think we'd get a lot of comment on it.

MR. BLACK. I know. That's my feeling, although I agree with what Paul suggested we do.

MR. BALLES. Well, I think the market would read more into the narrowing of the range than most of us would want read into it. And I think we'd be going the wrong way in any event.

MR. BLACK. Yes. I always favor no range--no limits really.

MR. BALLES. Yes. I'm in favor of a broader, not a narrower, range.

VICE CHAIRMAN SOLOMON. Well, if we choose [the wording] "unusual volatility," we haven't any range. Some of you are--

MR. PARTEE. It's just a question of the definition of "unusual volatility."

MR. MARTIN. We have a very [unintelligible] word in here.

MR. BLACK. Yes, all volatility is unusual but some is more unusual than others.

CHAIRMAN VOLCKER. It has to be pretty darn unusual to be unusual compared to what we've had!

MR. WALLICH. Well, they probably will think when they read this seven weeks from now that we thought the banking system was even more delicate than it had appeared to the market. I'm not sure that that is a good signal to give them ex post.

MR. PARTEE. It might be a self-fulfilling forecast.

CHAIRMAN VOLCKER. Well, they already think that. I've looked at this from that point of view. I'm not sure that that will aggravate what they already think.

MR. MARTIN. What they think is that we provide reserves. They are not focusing on the interest rate movements, are they? Because this rate says something else.

CHAIRMAN VOLCKER. I think it sounds more exceptional the way I suggested, in a temporary sense, than narrowing the range. Both ways substantively are pretty much the same thing. I think what the market is going to say is that we had had a sharp decrease in rates and we were a little concerned about the volatility in rates. That's given against the background of the markets and everything else. I think that's a correct reading.

MR. BLACK. I suppose it's conceivable that they could think this "unusual volatility" wording was a widening of the range or an elimination of the range if we haven't specified any range. They could come out that way. I don't know.

MR. BALLES. Could you clarify please, Paul, how you phrased that? It was "unusual volatility" in what?

CHAIRMAN VOLCKER. "In credit markets" is what I have.

MR. FORD. Could you read that again please, Paul, so we can study it a bit?

CHAIRMAN VOLCKER. "The Chairman may call for consultation if it appears that pursuit of the monetary objectives and related reserves paths during the period before the next meeting is likely to be associated with unusually volatile conditions in credit markets."

VICE CHAIRMAN SOLOMON. So you're leaving out the Manager for Domestic Operations?

CHAIRMAN VOLCKER. Well, I'm leaving that out, yes.

VICE CHAIRMAN SOLOMON. In other words, the judgment is the Chairman's without any advice.

MR. PARTEE. It's "is likely to be associated" too, not "because of unusually volatile conditions."

MR. ROOS. Well, is there anyone in the markets who doesn't think that if there were an unexpectedly volatile occurrence in credit markets that we would not consult? They assume that, don't they? In other words, do we have to tell them that exactly? Obviously, we'll accept your phone call, Mr. Chairman, any time. But do we have to say it? I just don't like to rock the boat.

MR. MARTIN. If the phone system works!

CHAIRMAN VOLCKER. Yes, if we had better technical apparatus, I assume.

MR. MARTIN. We may not be able to reach you, but--

CHAIRMAN VOLCKER. Well, the most important thing is agreeing on the substance. My sense is that there is a considerable area of agreement on the substance anyway. I'm not sure it's unanimous, but is that a correct reading? Are we reducing our focus to how to word this?

MR. FORD. I don't know that there is. I think we have a sizable minority who are concerned about sending out a signal that we're going back to managing interest rates.

MR. PARTEE. You meant the substance of what you thought the policy ought to be rather than what is stated here, right?

CHAIRMAN VOLCKER. Yes, I'm now talking about the substance, before we get to how we state it.

MR. PARTEE. If we have a shortfall in money growth, interest rates go down.

VICE CHAIRMAN SOLOMON. Or maybe Bill Ford is talking about the substance also.

MR. PARTEE. If we don't [have a shortfall in money growth], maybe they won't.

VICE CHAIRMAN SOLOMON. If he thinks that the substance of 7 to 10 percent, roughly, is going to be a constraint, maybe he's concerned about the substance too. I don't know.

CHAIRMAN VOLCKER. Well, let me resolve the substantive issue. As I say, I'm not all that concerned about the precise numbers we put down here. But just for lack of anything better, I'm assuming we will keep them the same as before with the modifying sentence that comes afterwards, which says that at the moment we're not too concerned about M2 at the very least running high. And if the aggregates appear to be running low, we will lean on the somewhat easier side, which presumably would be accompanied in the first instance by some continuation of the decline in money market rates, some easing pressure in reserve positions, a decline in the discount rate or some combination thereof. If money growth seems to be exceeding those numbers and getting a certain amount of momentum, we would snug up a bit. But we are not going to react very drastically one way or the other in these coming weeks. That's the substance of it.

MR. FORD. Yes, except--

CHAIRMAN VOLCKER. And we keep an eye toward the market. Now, you may or may not accept that. I wonder how many people find that substance generally acceptable.

MR. MARTIN. I certainly do.

MR. FORD. What I'd like to know is this. Right now the fed funds rate is 9 percent and we're talking about a period of six weeks between August 24th and October 5th. Are you really saying that you would define market conditions as volatile if in six weeks the fed funds rate went up by 2 percentage points from 9 to 11 percent?

CHAIRMAN VOLCKER. No, I might not if--

MR. FORD. How can that be volatile? If you look at a hundred years of history of short-term money rates, that has happened lots of times.

CHAIRMAN VOLCKER. Well, I can't define every possible hypothesis that one can put forward. This is operational. I would not necessarily find it volatile if it happened at the end of six weeks; I'd find it pretty volatile if it happened in the next two weeks.

MR. FORD. Well, obviously, the shorter the time horizon the more [it might be considered volatile]. I think if it happened in two minutes we'd all agree it's volatile. But we're talking about three to six weeks. And it really does bother me to think that every time we walk out of here we are setting--or it could be conceived that we are setting--a cap on the fed funds rate for six or eight weeks from now at either right where the rate is or a point above.

SPEAKER(?). Or four.

MR. MARTIN. But that's why we have the ability to consult.

MR. FORD. Yes, but then we're managing interest rates; that is the image given. I'm very worried as to how the market would take this.

MR. PARTEE. Bill, I think you're still talking about the wording in that suggested alternative. The trouble with "volatile" is that it means different things to different people.

MR. FORD. Yes.

MR. PARTEE. But the substance of the idea is that rates probably will go on down if we have weakness in money supply growth but they probably wouldn't go down, and they might even go up some, if M1 growth is at or right close to the 5 percent growth rate for the quarter. That's the substance, as I understand it. And I don't really see what we disagree about. But "volatile" is a funny word.

VICE CHAIRMAN SOLOMON. Much as it may surprise some of you, I also feel it would be a little disturbing to put in the phraseology "unusual volatility." We will get more stories, anyway, about our putting monetary policy on the back burner because of our concern about fragility. And even though we are doing that, in a certain sense we are not; we are luckily enough consistent with our monetary policy [targets] at the moment. It seems to me that it's more straightforward to say 7 to 10 percent with consultation. The fact that we narrowed the fed funds range to 3 points during a particularly difficult period doesn't mean we're going to continue it at 3 points. The following meeting we may go up to a 5-point range again.

SPEAKER(?). Yes.

MR. MORRIS. And 300 basis points is not managing interest rates. When we managed interest rates we had a 50 basis point range.

MR. RICE. As for the wording, why couldn't we say both? Why couldn't we have your language and then after "credit markets" say "or consistently outside a range of 7 to 10 percent." Either way the Chairman calls a consultation.

SPEAKER(?). Use both?

MR. RICE. Yes, he would call a consultation when markets are, in his judgment, volatile. But he also would call a consultation if the rate falls below 7 percent or goes over 10 percent.

CHAIRMAN VOLCKER. Express your view, Mr. Axilrod. Mr. Axilrod has a concern; I'm not sure if he will share it or not. I'm not sure I do, but--

MR. AXILROD. Well, I was just thinking of the image, since the Committee was discussing images. The image of a narrow range for the fed funds rate strikes me more as an effort to manage interest rates in this sensitive period as we go toward the elections than does worrying about the volatility of credit markets. The latter does not imply to me volatility in the funds rate, as it did to President Ford, but volatility in bond markets and other markets; a little funds rate increase might have very severe repercussions on those markets. So, that's the context in which I would have thought about volatility, not just the funds rate movement per se.

MR. RICE. Well, Mr. Chairman, what about using both?

CHAIRMAN VOLCKER. How do we use both?

MR. RICE. Just put "or outside a range of 7 to 10 percent" after "credit markets."

MR. PARTEE. I don't know about that.

MR. BLACK. A kind of footnote, which means a certain--

MR. RICE. No, it's not over [unintelligible]. These are two different circumstances. One is a matter of the Chairman's judgment as to volatility and the second is objective--if the market produces rates at a certain level, that automatically triggers a consultation. And that takes care of everybody's concerns.

MR. PARTEE. If we're going to do that, I would rather have the funds rate limitation and then add another proviso saying that this is for consultation. Remember, Emmett, what we are talking about is consulting with the Committee. If unusual instability develops in the credit markets, which is an obvious reference to bank problems--I prefer "instability" to "volatility," I think--

MR. RICE. That's fine.

MR. CORRIGAN. I'm getting more and more nervous about this [wording]. Again, I have no problems with any of this, but this language or prospective language about unusual volatility or instability or whatever we put in there runs at least some risk, it seems to me, of a self-fulfilling prophecy down the road.

MR. FORD. The market will wonder why [we said that].

MR. CORRIGAN. I started out liking it, but I'm getting more and more gun-shy about it. I'm not sure it's the right way to go.

CHAIRMAN VOLCKER. I'm not sure I understand the point.

MR. RICE. Why is it self-fulfilling?

MR. CORRIGAN. What I'm suggesting is that when that language is published, even though it will be some time from now, it entails some risk--and I didn't think it was much until I listened to this discussion--that we are telling the world that things are a lot worse than the world thinks they are.

MS. TEETERS. I think they're pretty bad.

CHAIRMAN VOLCKER. Oh, boy.

MR. CORRIGAN. That's precisely what worries me. As I listen to the discussion, I'm beginning to think it's a bit too much of a red flag.

MR. ROOS. Haven't we had a 500 basis point fed funds range for a long time?

SPEAKER(?). Four or five [months].

MR. ROOS. Four or five. We're leaving the aggregate targets about where they are. Why don't we set a broader range and, certainly, if something unforeseen happens, the Chairman will call a consultation. Why do we have to spell it all out? I think the important thing is not to deviate from what we've done, because we don't want to cause anyone to misconstrue that we've made a major change in our policy prescription.

MR. BALLES. I think there's a lot to be said for that. We have lived with this 5-point range now for some time. Has it been a problem in the last six weeks? If it was, it has not been notable to me. I still wonder why you want to narrow it.

MS. TEETERS. If our concern is mainly on the upper side and we want to maintain the 5-point range, then it ought to be 5 to 10 percent. That signals very clearly that we don't want to go above 10 percent on the funds rate. I don't particularly want to go down to 5 percent at this point, but our overwhelming concerns are upward, not downward.

MR. FORD. Well, if I heard correctly Paul's response to what I asked, he said that if the funds rate were 11 percent six weeks from now it would worry him a lot less than if it were 11 percent tomorrow.

CHAIRMAN VOLCKER. It depends upon what else is happening during that period.

MR. FORD. Depending on what else is happening. When I look at what has been happening at the Desk in New York in terms of the Manager making adjustments in the reserve paths for various reasons at various times, it seems to me that we still have the latitude to take into account what is happening, how fast it is happening, and so on, without giving this overt signal in the directive. That's why I say stick with a range of 5 points. If we don't want to center it on where the funds rate is, center it a little below where it is if our bias is in favor of seeing rates come down, and certainly mine is. Then use discretion at the Desk to see that it doesn't happen in two days rather than two months. Then we'd have a much stronger consensus on the Committee and the market would be less likely to misread the strong change in language.

CHAIRMAN VOLCKER. Well, I'm not very impressed by putting down language we don't believe.

MR. CORRIGAN. Why don't we put some language in there that doesn't have those sensational sounding adjectives. Use a range of 7 to 10 percent, say, but add a phrase such as "giving due regard to evolving financial and credit market conditions." That gives some greater flexibility without--

MR. ROOS. Isn't that implied, Jerry? We have always given regard to these things.

MR. CORRIGAN. Well, no. I think what Paul is looking for is something a little more than that.

MR. PARTEE. For a change we are going to look at credit conditions. "Giving due regard to unusual credit conditions" or something like that.

MR. BALLES. The trouble is "credit conditions" is an undefined term. The market will want to know what we mean. I'm not even sure we can agree around the table what we mean.

MR. FORD. Isn't that less information? The market is supposed to have good information from us, not something more vague.

MR. PARTEE. Well, we could make it more neutral and have "or if such consultation is indicated by credit market conditions." That's very neutral. But, then, why would we put it in?

CHAIRMAN VOLCKER. Yes, I think that's worse from that standpoint.

VICE CHAIRMAN SOLOMON. I think what does the least damage in terms of market perception, if we're going to be honest about it, Mr. Chairman, is the narrower range of 7 to 10 percent. Otherwise, there will be a lot of speculation as to what "unusual volatility in credit markets" means and some further stimulation to the belief that we are putting monetary policy on the back burner. Whereas if we say 7 to 10 percent, they will know that we just don't want too much movement in the period ahead.

CHAIRMAN VOLCKER. We can use this phrase about a distinction between monetary policy and something else. I know what you mean, but I don't think the distinction exists in reality. It's all monetary policy.

VICE CHAIRMAN SOLOMON. Yes, I know, but it's a way of putting it.

MR. MARTIN. [The distinction is] monetary targeting.

VICE CHAIRMAN SOLOMON. The alternative, basically, would be Bill Ford's suggestion of 7 to 12 percent with a private understanding that it's really 7 to 10 percent. And that has disadvantages, too.

MR. PARTEE. The rate is around 9 percent now, isn't it? How about 7 to 11 percent? It's neutral.

MR. FORD. At least that's within the range of ranges we have been using.

MR. PARTEE. And we had a 400 basis point range not too long [ago].

MR. MORRIS. That's a Las Vegas range!

MR. BALLES. It may be a good compromise.

MR. FORD. And at least that's as narrow as we've had it in the last year.

MR. PARTEE. For a couple of years we had a 400 basis point range, as I recall. Do you remember, Normand? Do you have a record? We had 400 basis points quite a lot.

CHAIRMAN VOLCKER. Oh, we've had it many times.

MR. FORD. That wouldn't be as unusual as the other stuff.

CHAIRMAN VOLCKER. It's not unusual at all. We've had it as much as not.

MR. FORD. I'd rather go along with that 7 to 11 percent idea than what we've had.

MR. BLACK. 6-1/2 to 11 percent?

MR. FORD. We've had 10 to 14 percent and we've had 11 to 15 percent; we've been as narrow as 4 points.

CHAIRMAN VOLCKER. Well, what do you want to do?

MS. TEETERS. Let's make it 4 points.

MR. MARTIN. 7 to 11 percent.

CHAIRMAN VOLCKER. Well, I don't like it much, but if that's what you want to do, let's do it. Let's have a vote.

VICE CHAIRMAN SOLOMON. Borrowing is what--$300 million?

CHAIRMAN VOLCKER. $300 million or a little above.

MR. CORRIGAN. Why don't you have a show of hands on--

CHAIRMAN VOLCKER. $300 to $350 million. Vote.

MR. BALLES. Excuse me, what are the Ms we are voting on?

CHAIRMAN VOLCKER. The same as it was, 5 and 9 percent [for M1 and M2 respectively]. The second sentence has "continuing;" the third sentence is out; we put in 7 to 11 percent down at the bottom; and initial borrowing is $300 to $350 million with appropriate adjustments for exceptional borrowing.

MR. BALLES. Okay.

MR. BERNARD.

Chairman Volcker	Yes
Vice Chairman Solomon	Yes
President Balles	Yes
President Black	Yes
President Ford	Yes
President Horn	Yes
Governor Martin	Yes
Governor Partee	Yes
Governor Rice	Yes
Governor Teeters	Yes
Governor Wallich	No

The vote is 10 to 1.

CHAIRMAN VOLCKER. Okay. I guess we will eat in here, right? Do we have anything else?

MR. BERNARD. The next meeting is October 5.

END OF MEETING